1. We are interested in the exchange rate between dollars and pounds. The graph below represents the \( \text{RET}^\text{US} \) and \( \text{RET}^\text{F} \) schedules. Clearly label both axes and both lines. Label the initial equilibriums with 0 subscripts.

Assume prices in the US are expected to increase. To determine what happens to today’s spot exchange rate you need to think about how this change might alter the return to investing in the US and the return to investing in the UK. We assume interest rate parity will hold.

a. Write out the equation that must hold if interest rate parity holds? Explain the meaning behind this relationship.
b. Will the change in US prices alter the expected exchange rate? If so, how? Explain.
c. Will the change in US prices alter the return to investing in the UK? If so, how? Explain.
d. Will the change in US prices alter the return to investing in the US? If so, how? Explain.
e. Show the effects of the expected increase in US prices on the graph depicting the returns on domestic and foreign investments.
f. Will the immediate effect be dollar appreciation or depreciation?

Do the above separately for increases in domestic interest rates, increases in foreign interest rates, increases in expected inflation in the US, and increases in the money supply in the US.

2. How does the existence of the FDIC alter your behavior? Explain. This is an example of what phenomena?

3. The 90-day forward exchange rate between the US dollar and the French Franc is 1.8 FF/$. However, you believe that in 90 days the spot rate will be 2 FF/$. You will have exactly $2,000 to used for this investment in 90 days.
   a. Based on your belief, what agreement would you be willing to make today? Be specific.
   b. Assuming you are correct, briefly describe the transactions that will take place in 90 days.
   c. Assuming you are correct, what will be your profit from this investment?

4. The current spot exchange rate between dollars ($) and yen (¥) is 200¥/$, the 90-day forward rate is 250¥/$, and the 90-day interest rate in the U.S. is 12%.
   a. If covered interest parity holds, determine the 90-day interest rate in Japan. Show the equation you are using for full credit.
   b. Assume that you believe the spot rate will be 300¥/$ in 90 days. Explain how you could speculate using this information? Assume you will have $1,000 to exchange in 90 days. Determine how much money you will have if you are correct. Be very specific regarding the agreement you will make today and the transactions that will take place in 90 days.

5. Why are financial intermediaries and indirect finance so important in financial markets? What important roles do financial intermediaries play?

6. Only large, well-known corporations have the ability to raise funds in the securities markets. Why?

7. Why are restrictive covenants an important part of debt financing?
8. Describe the asymmetry of information in financial markets. What problems arise due to the asymmetry of information? Explain. Explain the concepts of moral hazard and adverse selection. Give examples. What tools are used to control the problem of adverse selection? Describe the principal-agent problem that arises in securities markets. What tools are used to help control the principal-agent problem? What tools are used to help control the moral hazard problem?

9. Answer the following questions concerning the monetary authorities:
   a. How many members are there on the Board of Governors?
   b. How many voting members are there on the FOMC? Who are the voting members of the FOMC?
   c. What does FOMC stand for?
   d. Are there any voting members of the FOMC that are not appointed by some government agency or entity? If so, who? Briefly explain how they become members.

10. a. Assume the six-month interest rate in Russia is 32%, the current spot exchange rate is 14 (Roubles/$), and the spot exchange rate is expected to be 17.5 (Roubles/$) in six months. If interest rate parity holds, determine the six-month interest rate in the US. Show the equation you use for full credit.
   b. Assume instead that the \( \text{RET}_{US} > \text{RET}_{Russia} \). Carefully explain the behavior of investors that ensures markets will adjust so interest rate parity will eventually hold. Be sure to explain what variables will be changing and how this change will bring about parity.

11. We want to predict what happens to the peso/dollar spot exchange rate if the US increases tariffs on Mexican imports.
   a. The graph below is used to examine the returns to investing in the US and in Mexico. Label the function giving the return to investing in the US as \( \text{RET}_{US} \) and the function for Mexico as \( \text{RET}_{MEX} \).
   
   ![Graph](image)
   
   b. Does the change in tariffs alter the expected return to investing in the US? Explain. Use the equation that gives the return to investing in the US in your explanation. If \( \text{RET}_{US} \) changes, show this in the graph above.
   c. Does the change in tariffs alter the expected return to investing in Mexico? Explain. Use the equation that gives the return to investing in Mexico in your explanation. If \( \text{RET}_{MEX} \) changes, show this in the graph above.
   d. Show the new equilibrium in the above graph.
   e. Does the dollar appreciate or depreciate relative to the Mexican Peso? (Circle one.)

12. The 30-day forward exchange rate is 1.4 euros/dollar. However, your research indicates that the spot rate in 30 days will be 1.6 euros/dollar. Assume you will have $1,000 available to you in 30 days. You decide to speculate in the forward market.
   a. What transaction will take place in the spot market in 30 days? Be specific.
   b. What agreement will you make concerning the forward market? Be specific.
   c. If your analysis is correct, determine your profits (in dollars).